A WISE DECISION? AN ANALYSIS OF THE RELATIONSHIP BETWEEN CORPORATE OWNERSHIP STRUCTURE AND DIRECTORS’ AND OFFICERS’ DUTIES

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I. INTRODUCTION

In recent years, there has been a significant amount of commentary on the relationship between corporate ownership structure and corporate performance. The discussion includes examinations at the macro and micro levels. Scholars have examined how the ownership structure of a particular firm influences its performance, but have also examined ownership patterns and performance at the national level. One of the interesting lines of inquiry has investigated the relationship between the legal framework and institutions of a country and how they influence corporate ownership...
structure and performance.\textsuperscript{3} There has been relatively little commentary, however, on how ownership structure should affect particular aspects of the law, at least in developed countries.\textsuperscript{4} Moreover, scholarship analyzing the relationship between law and ownership structure has dealt with law in very general terms.

Daniels and MacIntosh suggest that ownership structure may well be relevant to an optimal corporate law regime;\textsuperscript{5} this article pursues this idea. In it I examine the relationship between ownership structure and the optimal application of the corporate law duties of directors and officers.\textsuperscript{6} It is my contention that ownership structure should inform how courts approach these duties. In particular, following a contractual model of the corporation and corporate law, I contend that courts should be even more cautious than usual in finding liability under the duty of care where there is a controlling shareholder structure. As I will explain, this is because violations of the duty of care will rarely make economic sense in such a setting.

On the other hand, questions of fiduciary duty are particularly important in a controlling shareholder setting and courts should be especially vigilant with respect to these duties. Motivating this analysis is a recent case in the Quebec Superior Court, \textit{Peoples Department Stores Inc. v. Wise},\textsuperscript{7} that in my view failed to take sufficient heed of the different standards to be applied in duty of care and fiduciary duty cases, which was particularly problematic given the ownership structure of the corporation in question.

The article proceeds as follows. Section II outlines the role and function of the directors' and officers' duty of care and fiduciary duties. This section reviews the contractual approach to the corporation and the position of directors' and officers' duties within this


\textsuperscript{4} There has been writing suggesting how to improve corporate and securities law in developing countries: see, e.g., Coffee, \textit{ibid.}; B. Black, “The Legal and Institutional Preconditions for Strong Stock Markets” (2000), 48 U.C.L.A. L. Rev. 781.

\textsuperscript{5} R. Daniels and J. MacIntosh, “Toward a Distinctive Canadian Corporate Law Regime” (1991), 29 Osgoode Hall L.J. 863 at pp. 884-88.

\textsuperscript{6} See Ontario Business Corporations Act, R.S.O. 1990, c. B.16 (hereafter OBGA), s. 134; Canada Business Corporations Act, R.S.C. 1985, c. C-44 (hereafter CBCA), s. 122. The oppression remedy may also be relevant to directorial duties; see OBGA s. 248; CBCA s. 241.

\textsuperscript{7} [1998] Q.J. No. 3571 (QL) (S.C.). This case is presently on appeal to the Quebec Court of Appeal.
context. Section III examines the particular issues that arise where there is a controlling shareholder. Section IV applies the analysis to *Wise*. An important finding in *Wise* was that directors of a corporation that is insolvent, or that is inevitably becoming insolvent as the result of the directors' actions, owe their duties to creditors rather than shareholders. While this finding was crucial to the result in *Wise*, and may have significant jurisprudential implications,8 I will focus on the court's approach to the content of directors' duties.9 It is my contention that the court failed to appreciate the important distinction between the standard to be applied to the duty of care and the standard that is relevant to fiduciary duties, or what Americans call the duty of loyalty.10 The court applied a standard to the duty of care which, particularly given the ownership structure of the corporation involved, was excessively strict from an economic perspective. As I will explain, the court may have felt itself constrained by circumstances imposed by the parties, yet its decision risks blurring an important distinction between the duty of care and fiduciary duties, a distinction that courts ought to respect in every case, but especially where there is a controlling shareholder.

II. THE CORPORATE CONTRACT AND DIRECTORS' AND OFFICERS' DUTIES

1. The Corporate Contract

In a famous and influential article, Jensen and Meckling describe the firm as nothing more than a “nexus of contracts”.11 In what will form the basis of the analytical framework employed in this article, the authors suggest that corporations permit a variety of


9. For a view on the question of whether creditors ought to be able to bring an action on behalf of an insolvent corporation, see E. Iacobucci and K. Davis, “Reconciling Derivative Claims and the Oppression Remedy” (2000), 12 Sup. Ct. L. Rev. 87 (it is appropriate in some circumstances for creditors to be able to bring an action on behalf of the corporation).

10. I will follow the convention in J. Ziegel, R. Daniels, J. MacIntosh and D. Johnston, *Cases and Materials on Partnerships and Canadian Business Corporations*, 3rd ed. (Toronto, Carswell, 1994) and will make a distinction between the duty of care, which involves negligence, and fiduciary duties, which involve, generally speaking, conflicts of interest.

parties to contract with one another. These contracts between various parties are both true contracts and metaphorical contracts. Trade creditors, for example, may have true contracts for the sale of goods with the corporation. Employees may also have employment contracts with the corporation. Shareholders, on the other hand, have a metaphorical contract with the firm. They contribute capital or some other consideration (such as labour) to the corporation in exchange for consideration in the form of legal rights, such as a right to dividends, or a right to receive proceeds on the winding up of the corporation. The legal rights shareholders have under the CBCA and cognate statutes are not truly contractual; rather they are found in the corporate law statutes themselves and in the corporation’s articles, by-laws and unanimous shareholders’ agreements. Shares under these statutes are metaphorical contracts.

There is a wide variety of parties to the "corporate contract". The corporation as a legal person serves to facilitate their contractual interaction. Rather than attempting to contract with each shareholder, for example, trade creditors simply contract with the corporation. The same is the case with employees, customers and creditors generally.

Viewing the corporation as a nexus of contracts has important policy implications. The parties to the corporate contract are generally the ones who bear the costs of the corporation’s failure or who reap the benefits of success. As a general proposition, then, it is good public policy to allow those affected by the corporate contract, the parties directly implicated in it, to determine the terms of

12. The view that the corporation is nothing more than a nexus of contracts is not universally held. For example, Chapman provides a thoughtful examination of the role of trust in the corporation: B. Chapman, “Trust, Economic Rationality, and the Corporate Fiduciary Obligation” (1993), 43 U.T.L.J. 547. In this article, however, I proceed from the contractual view of the corporation and examine its implications for directors’ and officers’ duties and ownership structure.

13. In memorandum jurisdictions shareholders (“members”) are viewed as a matter of law, not simply metaphor, as having contracts with the firm. See Ziegel et al., supra, footnote 10, at pp. 263–64. Under the CBCA and cognate statutes, shareholders are not in a contractual relationship with the firm as a matter of law. Idem.

14. A shareholder could not qua shareholder sue management for breach of contract, for example, but must depend on the remedies offered by the articles of incorporation, the by-laws and the statute.

the (metaphorical) contract. Legislators are unlikely to have the correct incentives, or adequate information, to structure a particular corporate contract optimally.

This analysis does not, however, preclude a useful role for corporate law. When the parties to the corporate contract establish a corporation, there may be certain provisions that most parties in most corporations would want included. Corporate law provides the parties with a quick and efficient method of adopting such rules. That is, corporate law provides an “off-the-rack” standard-form contract that reduces transaction costs. It is efficient because incorporators do not have to explicitly draft and redraft all terms of the corporate contract; rather, the act of incorporation itself is sufficient.

The transaction cost-reducing view of corporation law, also known as an “enabling” approach, has two important implications. First, terms in corporate law should generally allow the parties in any particular corporation to opt out of the default provision found in the standard form contract provided by the law. The parties bear the costs of failure, so let them decide how to avoid it. This enabling approach contrasts with a “regulatory” view of corporate law, which would require corporations to follow certain immutable rules. Empirically, it appears that the enabling approach is influential in Canadian corporate law statutes, with many provisions subject to revision by unanimous shareholders’ agreements, the articles of incorporation and/or by-laws.

Another implication of the contractual view is that corporate law statutes should attempt to provide terms that most parties would want. If the purpose of corporate law is to minimize transaction costs associated with establishing the corporate contract, it is optimal to give the parties default rules that they are less likely to wish to contract around.  

16. Easterbrook and Fischel, ibid. There are, however, circumstances where it may not be appropriate to rely on the parties to reach a socially optimal result. For example, where choosing the corporate contract signals information about the quality of the firm, it may be preferable from a social welfare perspective to restrict contractual freedom: E. Iacobucci, “Toward a Signaling Explanation of the Private Choice of Corporate Law” (2001) [unpublished]. Restricting choice may also be sensible where externalities to those outside the corporate contract are affected by such choice.

17. See discussion in Ziegel et al., supra, footnote 10, at pp. 399-401.

18. Ibid.

19. Ibid.

20. An exception to this “majoritarian” approach would arise where the default rule is efficient because it provides incentives to a party with hidden information to disclose the information to other contracting parties: I. Ayres and R. Gertner, “Filling Gaps in
This general analysis of the corporate contract leads to the question central to this article: what duties would most parties want corporate officers and directors to bear? To answer this question, it is important to understand the tensions that are present in the quasi-contractual relations between shareholders and directors and officers.

2. Agency Costs

The contractual view of the corporation sees shareholders as principals and directors and officers as their agents. Again, this is not a legal description flowing from agency law, but rather a metaphor for describing the relationship. Typically, shareholders provide capital to the corporation and delegate management to directors and officers, just as principals delegate tasks to agents in other settings. Unless the corporation has only a single shareholder, who is also the manager, and no debt, the private return to the directors and officers from the corporation’s performance will differ from the shareholders’ return. In a widely held corporation, for example, directors and officers typically hold only a very small fraction of shares and thus receive only a very small fraction of the returns from the corporation. The divergence between the returns to shareholders and the returns to directors and officers creates potential conflicts of interest between the groups. With respect only to those gains and losses that arise from share ownership, gains to the corporation as the result of diligent work by officers do not translate into gains for the officers. On the other hand, losses resulting from managerial slacking do not translate into losses for the officers themselves. While there may be sources of incentives for managers other than share ownership, such as executive compensation and managerial

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Incomplete Contracts: An Economic Theory of Default Rules” (1989), 99 Yale L.J. 87; see also C. Goetz and R. Scott, “The Limits of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms” (1985), 73 Cal. L. Rev. 261. While corporate fiduciary rules may have information-forcing properties because of the various steps fiduciaries must take to cleanse a transaction of the taint of self-interest, these properties arise without parties contracting around the fiduciary rules; rather, the rules themselves are structured to encourage disclosure. For example, OBCA s. 132 requires directors to disclose the “nature and extent” of their interest in a self-dealing transaction.

23. That is, one with dispersed share ownership rather than a controlling shareholder.
reputations, which I discuss further below, these will be imperfect and the divergence in outcomes facing officers and directors and shareholders gives rise to what economists call "agency costs". Resources will be wasted as a result of managerial self-interest and shareholder efforts to limit self-interested behaviour. There are two types of agency misbehaviour that are particularly relevant to a discussion of directors’ and officers’ duties.

First, there is a risk that officers and directors will not work hard; they may "shirk". Effort is presumed to be costly to its provider. If an officer knows that her effort, which is costly to her to provide, will not result in private gains to her, there will be a temptation to shirk. That is, there will be temptation for directors and officers not to pay close attention to the affairs of the corporation, given that the return from the corporation's success or failure is not fully realized by them. Since the total return from the manager's effort may well exceed the private costs to her of providing the effort, shirking may result in a net loss to the shareholders and directors and officers.

A second relevant agency problem arises where directors and officers divert corporate resources to themselves. This diversion may occur in a variety of ways that fall short of outright theft. Directors and officers may self-deal on favourable terms to themselves, such as selling an asset to the corporation at an inflated price. They may appropriate corporate opportunities. They may pay themselves excessive compensation. Again, any loss to the corporation from diverting assets is not fully borne by the directors and officers themselves, yet they will realize the benefits of the diverted assets. There is an economic incentive to divert assets even if the private use of the assets by the manager is less valuable than the use of the asset within the corporation. Moreover, the prospect of diversion will make it costly for a corporation to raise outside financing: investors will be reluctant to invest given the risk of future managerial appropriation of corporate assets. This creates social losses.

Both shirking and diversion of corporate resources can be inefficient in that their costs to the corporation may be more than the benefits they bring to the manager. In a contractual setting, parties seek to avoid inefficiencies, since eliminating them can bring gains to both parties. Eliminating inefficient self-dealing, for example,

would benefit the shareholders by reducing the harm from diversion of assets, but could also benefit the manager since shareholders could profitably compensate them (perhaps with higher pay) for lost self-dealing benefits. This is because the costs of self-dealing exceed its benefits.

The corporate contract ought therefore to seek to eliminate inefficiencies presented by the agency relationship. However, it is very difficult to draft enforceable, specific contractual rules eliminating agency costs. For example, effort by officers and directors, even if observable, is unlikely to be verifiable in court.\textsuperscript{25} Therefore, the parties cannot explicitly contract over effort. And any attempt to contract over corporate results (the output) rather than effort (the input) is limited by at least three factors. First, even if a manager exerts optimal effort, the results may be poor because of many other contributing factors, such as other managers’ efforts and economic conditions. Contracting on a result therefore exposes a risk-averse manager to risk. This is costly. Second, some results may not be verifiable in court and thus not amenable to contract. Third, even if certain results were verifiable, it will be difficult \textit{a priori} to anticipate what results should arise from optimal effort, and therefore difficult to contract on results. As economic conditions change, different results will be optimal and it will be very difficult for the parties to provide in a detailed contract what results should be achieved in the future.

Asset diversion also provides a contractual quandary. There could be a bright-line rule on some matters, such as self-dealing: it could simply be prohibited. Indeed, this was the common law position.\textsuperscript{26} The difficulty is that it sometimes will be efficient to allow self-dealing.\textsuperscript{27} A transaction between an interested director or officer and the corporation may be the best one available to the corporation, particularly given a significant reduction in transaction costs relative to other potential transactions. Indeed, corporations in memorandum jurisdictions tended to contract around the prohibition on self-dealing where possible, allowing interested transactions


\textsuperscript{26} See, \textit{e.g.}, Aberdeen Railway v. Blaikie Bros., [1843-60] All E.R. 249 at pp. 252-53 (“It may sometimes happen that the terms on which a trustee has dealt or attempted to deal with the estate or interests of those for whom he is a trustee have been as good as could have been obtained from any other person; they may even at the time have been better. But still so inflexible is the rule that no inquiry on that subject is permitted.”)

\textsuperscript{27} The court in \textit{Aberdeen Railway}, \textit{ibid.}, acknowledges this.
where certain requirements, such as full disclosure and a vote of disinterested directors, were met.\textsuperscript{28}

Rather than attempting to strike a contract that spells out managerial obligations in every possible state of the world, which would be very costly even if possible, the corporate contract in part addresses agency misbehaviour through the imposition of general duties on directors and officers. They have a duty of care and fiduciary duties. Section 122(1) of the CBCA provides:

Every director and officer of a corporation in exercising his powers and discharging his duties shall,

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.\textsuperscript{29}

Thus, s. 122(b) sets out the duty of care, while s. 122(a) establishes directors’ and officers’ fiduciary duties.

The duties correspond to the agency problems identified above. The duty of care addresses shirking. A director or officer, if she is not diligent, is potentially liable for losses that result from her lack of diligence. This helps provide private economic incentives to the manager to be diligent and helps avoid the agency costs that result from shirking.

The fiduciary duties found in s. 122(a), on the other hand, address the temptation to divert assets. A director or officer is charged with acting in the best interests of the corporation. This implies that she cannot fill her own pockets at the expense of shareholders. If, for example, she pursues a business opportunity in her personal capacity that the corporation could have pursued, the general fiduciary duty will potentially require that she disgorge any profits she realized from the endeavour.\textsuperscript{30} Any tendency to self-deal or award herself excessive compensation also risks liability under s. 122.\textsuperscript{31}

\textsuperscript{28} See Ziegel et al., supra, footnote 10, at p. 537. Examples are found in Transvaal Lands Co. v. New Belgium (Transvaal) Land and Development Co., [1914] 2 Ch. 488 (C.A.) and The Liquidators of the Imperial Mercantile Association v. Edward John Coleman and John Watson Knight, [1873] L.R. 7 E.&I. App. 189 (H.L.), which involved companies that had allowed for self-dealing if these requirements were met.

\textsuperscript{29} See also OBCA, s. 134(1).


\textsuperscript{31} Self-dealing is permissible under CBCA s. 120 if the deal is fair and reasonable to the corporation, there is full disclosure, the director does not vote and, where directors would vote on the matter in question, the disinterested directors approve the transaction; see OBCA s. 132. Under OBCA s. 132(8), the shareholders can approve the transaction by special resolution (i.e., a two-thirds majority).
These duties are broadly worded. By incorporation, the business organization establishes rules that will govern directors and officers in a variety of circumstances that the parties do not have to describe in detail. Courts will interpret the duties based on the facts before them and on prior case law. A sophisticated, nuanced term of the contract between shareholders and directors and officers arises simply through incorporation, thus saving the parties transaction costs.\(^{32}\)

3. The Standards

While the duties are easy to state and briefly describe, it is necessary to look to the case law to understand their importance in practice. The stringency of scrutiny depends considerably on the type of duty in question. Stated briefly, the standard of scrutiny is more relaxed under the duty of care than under fiduciary duties.

Early cases established the relaxed standard in adjudicating the duty of care. The courts in \textit{City Equitable Fire Insurance Co. (Re)}\(^{33}\) and \textit{Brazilian Rubber Plantations and Estates Ltd. (Re)}\(^{34}\) set out that directors and officers would not be liable for “errors in judgment”, but rather must avoid only “gross negligence”. In those cases, the courts further held that directors were not required to give continuous attention to the company, or even to attend board meetings. Rather, unless there were grounds for suspicion, directors were entitled to rely on reports from other managers. Moreover, managers were held to a subjective standard: they were judged according to their personal knowledge and experience.

Today, the rule has been tightened in some ways. Some cases have required directors to pay continuous, if not close, attention to the company,\(^{35}\) and \textsc{CBCA} s. 123(1) provides that absent directors are deemed to agree to actions taken at meetings unless they lodge a written dissent.\(^{36}\) Section 122 makes the test largely objective, referring to a “reasonably prudent person” in the circumstances rather than a

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\(^{32}\) Easterbrook and Fischel, \textit{supra}, footnote 15. There may be a contractual question of whether managerial duties should be optional. Since the purpose of this article is to examine the substance of the duties depending on ownership structure, I will not engage the question of whether they should be mandatory.

\(^{33}\) (1925) 1 Ch. 407 (C.A.).

\(^{34}\) (1911) 1 Ch. 425 (C.A.).


\(^{36}\) See \textsc{OBCA}, s. 135(1).
than a person of the director’s “knowledge and experience”. However, the “gross negligence” standard continues today. 37 Canadian law in this respect resembles American corporate law, which relies on a “business judgment rule”. This rule establishes a presumption that directors have acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the corporation. 38 Unless there is evidence challenging this presumption, which includes evidence of gross negligence, the decisions of directors are insulated from liability.

There are several reasons why this deferential standard represents what the parties would want, and therefore comports with a contractual view of corporate law. 39 As noted already, effort is not easily verifiable in a courtroom. Courts therefore cannot easily examine the facts and determine whether effort was exerted. Typically, all they can do is infer effort and diligence from outcomes. Such an inference is very difficult to make, however, for a number of reasons. First, courts will be examining decisions only after they have turned out badly; if they turn out well, it is unlikely that a suit against directors will be launched. Many business decisions, however, may be reasonable, or indeed optimal, and made on the basis of diligence at the time they were made, yet they turn out badly. Uncertainty is a constant in the business realm. However, having observed a decision and its poor outcome, it may be difficult for courts to avoid a “20/20 hindsight” bias in evaluating decisions. Countering this bias with a relaxed standard of care is sensible.

A second reason why courts can only imperfectly adjudicate the duty of care is that the decisions to be evaluated are business decisions. Judges are not appointed for business expertise and adjudicating whether a decision was a good one will not be a task for which they are generally suited. This relative lack of expertise combined with the risk of a hindsight bias behooves caution.

The risk of error that would result from a strict application of the duty of care is therefore significant. This would in turn result in costs to the corporation in the form of higher liability insurance premia, or perhaps worse, excessive caution from directors fearful

37. See discussion in Wise, supra, footnote 7. As I will develop below, in my view the court in Wise failed to heed the deferential standard on the duty of care that it purported to follow.
of making risky decisions that may result in liability. A stringent
duty of care could chill risky but wealth-maximizing business
decisions. The business judgment rule, or absolving directors from
liability for “mere errors of judgment”, limits these costs.

U.S. courts have attempted to gauge directorial effort more
directly, grounding liability for breaching the duty of care on the
failure to become informed.\textsuperscript{40} Such an approach, if applied too
zealously, is problematic.\textsuperscript{41} The weakness of the approach is that the
decision on how much information to gather is itself a business
decision. Information is costly and directors should gather it only if
its benefits outweigh its costs. When courts enforce the duty of care
on the basis of whether the decision was informed, they risk intrud-
ing into a business domain in which their legal expertise is of little
assistance and in which the risk of hindsight bias is significant.

While a strict duty of care would thus bring significant costs,
either when relying on an assessment of the decision itself or the
information behind it, it is also worth asking to what extent it
would bring benefits — the risk of judicial error is ubiquitous in
the law, but is often tolerated because stringent judicial scrutiny
can also give rise to significant benefits. However, there are several
reasons to suppose that a strict duty of care in the corporate context
would bring little benefit.\textsuperscript{42} First, unlike many other legal areas
where strict rules and therefore judicial error costs are tolerated, the
law is not the only significant source of incentives. Several markets
are important in disciplining management.\textsuperscript{43} The product market,
the market in which the corporation competes, is one source of
discipline.\textsuperscript{44} If the corporation continually fails in this market it is
unlikely to last, either because of bankruptcy where there is debt or
because of the absence of capital and consequent winding-up of the
corporation if there is not, resulting in the directors and officers
losing their jobs. The managerial labour market is another source of
discipline.\textsuperscript{45} Shirking by officers and directors and subsequently

\textsuperscript{40} Smith v. Van Gorkom, 488 A.2d 858 (Del. S.C. 1985).
\textsuperscript{41} The fallout from Van Gorkom resulted in Delaware’s decision to allow corporations to
waive liability for the duty of care in their certificates of incorporation: Ziegel et al.,
\textit{supra}, footnote 10, at p. 495.
\textsuperscript{42} Easterbrook and Fischel, \textit{supra}, footnote 15, at c. 4.
\textsuperscript{43} \textit{Ibid}.
\textsuperscript{44} See O. Hart, “The Market Mechanism as an Incentive Scheme” (1983), 14 Bell J. Econ.
366.
poor corporate performance will entail costs for them in the managerial labour market — their reputations, and future earnings, will suffer. Another source of discipline is incentive pay. Directors and particularly officers may be compensated on the basis of corporate performance, which increases the cost to them of shirking.\footnote{For an overview of the issues related to executive compensation, see E. Iacobucci with M. Trebilcock, \textit{Value for Money: Executive Compensation in the 1990s} (Toronto, C.D. Howe Institute, 1996).} Finally, there is the market for corporate control.\footnote{H. Manne, "Mergers and the Market for Corporate Control" (1965), 73 J. Pol. Econ. 110.} If the firm consistently performs poorly, this will increase the likelihood of a hostile takeover. Hostile takeovers tend to result in the replacement of directors and officers, so this threat too will provide incentives not to shirk.

The presence of these markets is not a sufficient reason to conclude that there will be little benefit from a strict duty of care, since they are by no means perfect in aligning managerial interests with those of shareholders. Product markets may not be perfectly competitive, for example, nor will the market for corporate control work perfectly because of the scope for defensive tactics that will deter hostile takeovers.\footnote{Courts have interpreted fiduciary duties to give directors and officers some leeway in erecting defensive barriers to a takeover. See, e.g., \textit{Teck Corp. Ltd. v. Millar}, [1973] 2 W.W.R. 385 (B.C.S.C.); \textit{Re Olympia and York Enterprises Ltd. v. Hiram Walker Resources Ltd.} (1986), 59 O.R. (2d) 254 (H.C.J.).} However, another factor is the absence of a strong private incentive to shirk. The private benefit from not taking care is essentially leisure time. Empirically, when compared with the potential private costs of shirking, such as a ruined reputation or a hostile takeover, the benefit is likely to pale. Consequently, imposing a strict duty of care will not provide significant disciplinary benefits.\footnote{Easterbrook and Fischel, \textit{supra}, footnote 15.}

The error costs of a strict duty of care in combination with its limited disciplinary benefits justify the relaxed standard that prevails in duty of care cases. The law will not significantly chill risk-taking, non-negligent behaviour, but will help deter blatantly negligent conduct. Such a relaxed standard, however, is not appropriate in evaluating an alleged breach of fiduciary duty. While the private benefits from the duty of care are small and entail incremental gains in leisure time, the private benefits from breaches of fiduciary duty could be very large, one-shot gains.\footnote{\textit{Ibid.}}
to the corporation at an inflated price or appropriating a corporate opportunity, for example, could result in a significant windfall for a manager. Consequently, market disciplines imposed by product markets, managerial labour markets, executive compensation and the market for corporate control may not be sufficient. A director may be willing to trade her reputation, or risk a takeover, for the significant pecuniary gains resulting from the interested transaction. Given the relative weakness of the market disciplines in the face of such temptation, there is a role for a strict application of fiduciary duties.

This is not to say that error costs will not exist in the application of a strict fiduciary duty. However, these costs are worth incurring to limit the otherwise significant temptation to divert corporate assets.

A stringent approach to fiduciary duties is what we observe. The Supreme Court in Canadian Aero Services v. O’Malley\(^5\) reviewed a number of decisions finding liability on the basis of a breach of fiduciary duty. In a passage that both emphasizes the strictness of the approach and acknowledges a concern about agency costs that motivates the duty, the court stated:

> What these decisions indicate is an updating of the equitable principle whose roots lie in the general standards that I have already mentioned, namely, loyalty, good faith and avoidance of conflict of duty and self-interest. Strict application against directors and senior management officials is simply recognition of the degree of control which their positions give them in corporate operations, a control which rises above day-to-day accountability to owning shareholders and which comes under some scrutiny only at annual general or at special meetings. It is a necessary supplement, in the public interest, of statutory regulation and accountability which themselves are, at one and the same time, an acknowledgement of the importance of the corporation in the life of the community and of the need to compel obedience by it and by its promoters, directors and managers to norms of exemplary behaviour.\(^6\)

In summary, a strict application of the duty of care would bring significant error costs and few deterrence benefits, since the temptation to shirk will not generally be strong. It is optimal, therefore, to impose a relaxed standard. A strict fiduciary duty, on the other hand, will bring significant benefits: it will deter the diversion of corporate assets that market disciplines may not. While a strict duty may entail error costs, they are justified in the

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51. Supra, footnote 30.
52. Ibid., at p. 610.
face of the temptation to divert corporate assets. This analysis comports with the law that exists.

III. OWNERSHIP STRUCTURE AND THE DUTIES OF DIRECTORS AND OFFICERS

The relationship between ownership structure and the appropriate approach to directors' and officers' duties is underappreciated in both the literature and the case law. In this section I will review how ownership structure, particularly that of equity, will affect incentives and ought therefore to affect the law of directors' duties.

Berle and Means famously expounded the concern about agency costs arising from the sale of shares to the public (the agency cost of equity). As managers own fewer shares, their incentive to pursue profitable opportunities diminishes. Jensen and Meckling formalized this concern, presenting a model of agency costs and the firm. They describe a manager's choice between using corporate resources to invest in ways that profit the corporation generally and using corporate resources to invest in perquisite consumption, including leisure time. Assuming that share ownership is the only source of managerial incentives, as managers own an ever smaller fraction of the firm's outstanding equity, the agency costs of equity increase. This is because the price facing the manager personally of perquisite consumption falls as her share of the firm's equity declines. On this analysis, the greater the proportion of inside ownership (shares owned by management), the lower the agency cost of equity. Along this "alignment of interests" dimension, concern about breaches of

54. As I will explain, Wise, supra, footnote 7, fails to account for ownership structure and incentives.
56. Jensen and Meckling, supra, footnote 11.
57. To demonstrate, suppose the manager values a week of leisure at $1,000, but this will result in forgone profit to the corporation of $1,500. If the manager owns 100% of the equity she will not take the week off. If, however, she owns less than two-thirds of the shares, she will have an incentive to shirk: the opportunity cost to her of taking the time off will be less than $1,000. Her benefits from shirking do not vary with ownership, but her costs do.
the duty of care or loyalty ought to decrease as inside ownership increases.

While the incentive to impose agency costs on the corporation through shirking or diversion would clearly weaken as share ownership concentration increased if share ownership were the only source of incentives for managers, the analysis is more ambiguous when other incentives are taken into account. In particular, some sources of discipline facing directors and officers may weaken as inside ownership increases. The most obvious reason for this is the stifling of the market for corporate control. At the extreme, if officers and directors own a controlling stake in the firm, they are insulated entirely from a hostile takeover, thus eliminating a potentially important source of managerial incentives. Moreover, controlling shareholders decide who sits on the board of directors, reducing the likelihood of detached scrutiny of management by the board. Controlling shareholders are also insulated from proxy battles. Thus, there are, to use the term found in the literature, “entrenchment” effects as ownership becomes more concentrated.

To summarize, if share ownership were the only source of managerial discipline, increasing ownership concentration would unambiguously improve managerial incentives. But since other sources of managerial discipline, such as the market for corporate control and board monitoring, diminish as share ownership increases, the effect of increasing ownership concentration is ambiguous.

While there are thus opposing alignment and entrenchment effects on agency costs as equity ownership concentration increases, it is reasonable to suppose that these effects will differ in their impact on the incidence of duty of care and fiduciary duty breaches. As noted, the gains from breaching the duty of care are small and incremental: the breacher gains some leisure time. The costs of shirking to the corporation, however, can be substantial. At very low levels of managerial ownership, it may be that the small private benefits of shirking exceed the costs. As ownership concentration increases, however, the manager bears a greater portion of the (relatively large) losses from shirking. Given its small gains, the alignment effect alone is likely to discipline such

58. See Stulz, supra, footnote 1; Morck, Shleifer and Vishny, supra, footnote 1.
shirking. Put another way, as ownership concentration increases, the insulation of managers from hostile takeovers, proxy battles and vigorous board oversight is unlikely to result in violations of the duty of care; the incentives of share ownership provide sufficient discipline.

On the other hand, the benefits from breaching fiduciary duties can be large and will not necessarily be deterred by alignment effects when ownership concentration increases. Since the potential gains to managers from diversion, net of the loss in the value of their shares from such agency misbehaviour, are potentially very large even as share ownership increases, the insulation of management from the market for corporate control, vigorous board oversight and proxy battles will potentially be important. Put another way, as ownership becomes increasingly concentrated, the incentive effects from higher share ownership will themselves deter duty of care breaches, but will be insufficient to deter duty of loyalty breaches. And since increasing ownership concentration diminishes discipline from sources other than share ownership, such as that generated by the market for corporate control, entrenchment effects will tend to encourage duty of loyalty breaches. The duty of loyalty becomes more significant in the face of ownership concentration.

There are nuances to this analysis that are worth exploring. First, what is the effect of the controlling shareholder not being the sole director or officer of the corporation? For example, an individual may own a majority of shares but may not manage the corporation herself. While this implies that the directors or officers who manage the corporation will not automatically suffer a significant opportunity cost from agency misbehaviour through diminished returns from equity, this does not sever the relationship between ownership concentration and agency costs. If there is a large shareholder, that shareholder will have strong incentives to monitor corporate management carefully. Moreover, the shareholder is in a strong position to influence managers: if a shareholder controls the corporation, directors can be removed by its votes alone.\(^\text{60}\) Controlling the board of directors in turn implies control of officers, since directors are responsible for appointing officers.\(^\text{61}\)

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60. CBCA s. 109, OBCA s. 122 provide that a majority vote is sufficient to remove directors from office.

61. CBCA s. 121; OBCA s. 133.
controlling shareholder manages herself or delegates management, there is less reason to expect shirking where ownership is concentrated, but there will remain concern about the diversion of assets from the corporation to the controlling shareholder.

Another nuance arises from the potential separation of "ownership" in the form of cash flow rights and voting power. There may be circumstances in which a person controls a majority of the votes of a corporation with fewer, or even radically fewer, than a majority of shares and consequent rights to cash flow in the form of dividends or proceeds on winding up. This could arise where there are multiple classes of shares, for example, with one class carrying voting rights disproportionate to its cash flow rights. It could also arise through a pyramidal ownership structure, with, for example, Corporation A owning 50.01% of Corporation B, which in turn controls 50.01% of Corporation C. Corporation A controls 50.01% of the votes of Corporation C but only has 25.01% of the cash flow rights. In these pyramid situations, it is not as clear that the controlling shareholder will have strong incentives to avoid managerial negligence, since its cash flow rights, and hence opportunity cost of shirking, may be little different from that of a very small shareholder in a widely held corporation. This suggests that the analysis should focus on the ownership of both cash flow rights and voting rights, not simply voting control.

A situation may also arise where a single entity does own a majority of cash flow rights as well as votes, yet there is a relatively low opportunity cost to managers of shirking and forgoing profits. This may arise where a widely held corporation, with little managerial ownership of shares, is the majority owner of a subsidiary corporation. Where the controlling shareholder of a corporation is itself a corporate entity, the ownership structure of the parent will be relevant to management's incentives.

To summarize, while ultimately an empirical claim, it is reasonable to suppose that the duty of care will be less important for firms with concentrated equity ownership, since the economic


63. A controlling shareholder with small cash flow rights will at least face attenuated incentives to free-ride on the monitoring of other shareholders since other shareholders are unable to elect management. However, it simply may not have sufficient incentives to monitor management, or to take care itself, given its small share of cash flow rights.
incentives to be negligent and shirk will fall as alignment increases. On the other hand, alignment is unlikely to eliminate the incentives to divert corporate assets, and increased entrenchment will hinder a variety of potential disciplinary influences, such as the market for corporate control.

There is a variety of findings on the empirical relationship between ownership structure and performance. Morck, Shleifer and Vishny, for example, found that at very low levels of managerial ownership, increasing managerial ownership improved corporate performance as measured by Tobin’s Q. This finding is consistent with the Jensen and Meckling analysis: greater insider ownership better aligns the incentives of managers with those of outside shareholders. On the other hand, at a certain level of insider ownership, increasing managerial ownership hinders the firm’s performance. This is consistent with the entrenchment concern. The authors also tentatively conjectured that as inside ownership grew still further, firm performance would improve again. This would be so because once entrenchment is complete (no hostile takeover could succeed), any increase of managerial ownership simply serves better to align managerial and shareholder interests.

This evidence does not prove that entrenchment encourages violations of fiduciary duties rather than breaches of the duty of care. It could be, for example, that entrenchment encourages negligence but that alignment discourages fiduciary breaches as ownership concentration increases. However, it is more plausible, as has been argued, to suggest that entrenchment encourages diversion while alignment discourages negligence. The evidence that firm value may decline as ownership levels increase may thus imply that fiduciary duties are particularly important where managerial ownership is significant.

An indirect way of testing the importance of fiduciary duties to control diversion is to examine what occurs in countries where there is considerable inside ownership and there are relatively few legal constraints on the self-interested diversion of assets, either because of the absence of legal rules prohibiting such behaviour,


65. Morck, Shleifer and Vishny, supra, footnote 1. Tobin’s Q is the total value of the firm’s debt and equity claims over the replacement cost (typically the book value) of the corporation’s physical assets.
or because of inadequate enforcement of these rules. In recent years, a number of studies have revealed that controlling shareholders in such countries do indeed siphon off assets from the corporation, reducing its value considerably.\textsuperscript{66} One of the terms for such behaviour emerging from Europe is "tunneling": insiders "tunnel" assets away from the corporation.\textsuperscript{67} This widespread diversion of assets has led commentators to acknowledge the importance of law and legal institutions in constraining insiders from diverting corporate assets.\textsuperscript{68} This indicates the importance of fiduciary duties in deterring diversion by directors and officers who are or who were appointed by controlling shareholders.

Both theory and evidence therefore suggest that shirking will be less important as ownership concentration increases. Fiduciary duties, on the other hand, will remain important and indeed may become more important as managers accumulate equity.\textsuperscript{69}

This analysis has both positive and normative implications. The positive prediction would be that in firms with concentrated ownership, plausible claims involving the duty of care will be rare. Perhaps supporting this prediction, Romano finds that shareholder suits involving duty of care allegations alone were associated with lower insider share ownership (on average 12\%) than insider ownership of firms dealing with other shareholder suits (25\%).\textsuperscript{70} In Canada, a large percentage of firms, even publicly traded firms, have controlling shareholders.\textsuperscript{71} This analysis suggests the relative lack of importance of the duty of care as a corporate governance tool in Canada.

\textsuperscript{66} See, \textit{e.g.}, the articles by LLSV, \textit{supra} footnote 2; Black, \textit{supra} footnote 4; Coffee, \textit{supra} footnote 3.

\textsuperscript{67} LLSV, "Tunneling" (2000), 90 Am. Econ. Rev. 22.

\textsuperscript{68} E. Glueker, S. Johnson and A. Shleifer, "Coase Versus the Coasians" (2001), 116 Quar. J. Econ. 865; Black, \textit{supra} footnote 4; Coffee, \textit{supra} footnote 3.

\textsuperscript{69} If Morck, Shleifer and Vishny, \textit{supra} footnote 1, are correct in finding that firm value falls as entrenchment increases, and if this results from increased diversion, then diversion and fiduciary duties are more important as ownership concentration increases.

\textsuperscript{70} R. Romano, "Corporate Governance in the Aftermath of the Insurance Crisis" (1990), 39 Emory L.J. 1155 at p. 1176.

\textsuperscript{71} Daniels and MacIntosh, \textit{supra} footnote 5, at p. 884 reported in 1991 that only 14\% of the Toronto Stock Exchange 300 were widely held; in contrast, 63\% of Fortune 500 were widely held. LLSV (1998), \textit{supra} footnote 2, report that 60\% of Canadian publicly traded firms did not have a controlling (20\%) shareholder; in contrast, 80\% of U.S. and 100\% of U.K. firms did not have a controlling shareholder. Of the 40\% of firms with a controlling shareholder in Canada, however, 15\% were controlled by a widely held corporation. This study, of course, only examines publicly traded companies. Controlling shareholders are undoubtedly more common in private corporations.
The normative implication is that courts should set a particularly deferential standard in reviewing whether directors and officers in a firm with a significant shareholder have violated the duty of care. This is because it is not economically plausible for such violations to occur. The risk of error and its attendant costs, combined with the lack of economic incentives to be negligent, behooves even more caution on the part of courts than when considering the duty of care in widely held corporations. A competition policy analogy is apt. When attempting to determine whether low pricing is predatory and thus illegal, antitrust authorities in Canada and the United States have established a threshold test. Unless it is economically plausible for the alleged predator to recoup the losses associated with predatory pricing, the authorities will not characterize the pricing as illegal. A similar approach is appropriate in adjudicating the duty of care. At high levels of managerial ownership, negligence is less plausible and violations of the duty of care should rarely, if ever, be found. Courts should focus on fiduciary duties in such contexts.

IV. APPLICATION: PEOPLES DEPARTMENT STORES INC. V. WISE

The analysis of the contractual role of the duty of care and fiduciary duties set out in Section II, as well as their relationship to ownership structure discussed in Section III, is useful in considering Peoples Dept. Stores Inc. v. Wise. Wise involved the bankruptcies of two department store chains, Wise Stores and Peoples. Questions of bankruptcy law and corporate law were at issue before Greenberg J. As noted in Section I, an important finding in Wise was that directors of a corporation that is insolvent, or that is inevitably becoming insolvent as the result of the directors’ actions, owe their duties to creditors. While this finding was crucial to the result in


73. There may be some circumstances where a controlling shareholder, perhaps an heir who has no interest in management (see R. Morck, D. Stangeland and B. Yeung, “Inherited Wealth, Corporate Control and Economic Growth: The Canadian Disease” in Morck, ed., supra, footnote 59), could be extremely neglectful of a company and thus liable. Thus a bright line rule of no liability is too strong, but inside ownership should be a factor implying a very cautious approach.

74. Supra, footnote 7.
Wise, I focus in this section only on the court's approach to the content of the directors' duties.  

1. The Relevant Facts of Wise

Alex Wise founded Wise Stores in 1930 with a single store in Montreal. In time, his three sons joined the business, the last joining in 1964. The firm grew gradually, reaching ten stores by 1980 with revenues of $10 million. In 1980, Wise Stores embarked on a rapid expansion. It took over the leases of 15 stores of a bankrupt rival chain in 1980 and its sales grew to $50 million by 1986. Wise Stores went public in 1986 and was listed on the Montreal Stock Exchange. By the early 1990s, following a series of acquisitions, the chain had grown to 50 stores with sales of about $100 million.

In 1992, Wise Stores acquired all the outstanding equity in Peoples Stores from Marks and Spencer Canada Inc. (MS) at a price of $27 million. The acquisition was financed through a loan of $5 million from the Toronto-Dominion Bank, with the balance of the acquisition price payable to MS over an eight-year deferred payment schedule. MS had a floating charge on all of Peoples' assets. One of the covenants in the purchase agreement was that Peoples could not furnish any financial assistance to Wise Stores.

The integration of Peoples and Wise Stores was not trouble-free. In particular, problems arose with the computerization of inventory purchasing and warehousing systems. Greenberg J. observes that, "Often, the computer systems would show no stock of a given item, whereas in the warehouse there was stock. Conversely, often when the computer systems showed stock of a given item, in the warehouse there was none."

In October 1993, Mr. Lionel Wise, an officer and director of Wise Stores, asked the Vice-President, Administration and Finance of Wise Stores and Peoples, David Clément, to devise a solution. Clément recommended changing the inventory procurement policy. Since the acquisition of Peoples, Wise Stores had effected all Letter of Credit "imports" (that is, from outside North America) for both companies and would bill Peoples for merchandise transferred to Peoples stores. As the court states, "[a]fter some study

75. For a view on the question of whether creditors ought to be able to bring an action on behalf of an insolvent corporation, see E. Iacobucci and K. Davis, supra, footnote 9.
76. Wise, supra, footnote 7, at para. 45.
and reflection", Clément recommended continuing this practice, but having all imported merchandise transferred en bloc to Peoples stores on arrival and charging Peoples accordingly. Peoples would in turn charge Wise Stores for any imported merchandise transferred to Wise stores. With respect to domestic inventory, the proposal would have Peoples make all domestic acquisitions and charge Wise Stores for any merchandise transferred to Wise. This system would eliminate the confusion that had plagued the warehousing system, as only one set of invoices, to Peoples, would be created for domestic inventory.

Greenberg J. notes, “Mr. Clément’s proposed solution was accepted by the [Wise brothers, who were directors of Peoples and Wise] after rather cursory consideration. It was done informally by brief consultations among the three brothers, with no formal resolution enacted by the Board of Directors.” The policy was put in place as of February 1, 1994.

Clément and the Wise brothers were of the view that the new system was adopted in the ordinary course of business and therefore did not require full board approval. Greenberg J. disagreed:

During his testimony, Mr. Clément opined that this whole matter was in the ordinary course of business and accordingly did not require any formal resolution of the Board of Directors. It would appear to the Court that the [Wise brothers] were of the same opinion, erroneously we would suggest. The new domestic inventory procurement policy was a major and drastic departure from the prior policy, with potentially disastrous financial consequences for Peoples.

The disastrous financial consequences realized their potential. The debt owed by Wise Stores to Peoples accumulated to a significant sum in a short time. The court found that the debt owed by Wise Stores, which was “almost totally the result of the new domestic inventory procurement policy . . . caused the demise of Peoples”. At the time of Peoples’ and Wise Stores’ coincident declarations of bankruptcy on December 9, 1994, the debt owed by the latter to the former was $16,210,661.

77. Ibid., at para. 50.
78. The court did not accept a further alleged benefit of the new system. Wise suggested that the new system would allow Wise/Peoples jointly to take advantage of volume rebates but, as the court notes, most suppliers were already extending such discounts.
79. Wise, supra, footnote 7, at para. 56.
80. Ibid., at para. 57.
81. Ibid., at para. 72.
82. Ibid., at para. 70.
2. Ownership Structure and Governance

The three Wise brothers controlled Wise Stores before and after its acquisition of Peoples. Prior to 1986, Wise Stores was a private company. In 1986, it went public. It had two classes of shares, one with multiple voting shares. The Wise brothers held a majority of shares. According to Greenberg J.'s reasons, the Wise family had a 75% equity stake in Wise Stores.\(^3\) This was an economically significant stake. In 1993, without affecting their control of Wise Stores, Greenberg J. reports that the Wise brothers sold a fraction of their shares for a total of $15 million.\(^4\)

The controlling stake in Wise Stores implied a controlling stake in Peoples, since Wise Stores owned 100% of the equity of Peoples. The Wise brothers were directors of Wise Stores and were the sole directors of Peoples.

While there were no minority shareholders of Peoples, there were significant creditors of Peoples and Wise Stores. MS, for example, was owed $22 million by Peoples. The domestic procurement system clearly disadvantaged these creditors. The debt owed to Peoples by Wise Stores because of inventory procurement was never formalized, so no penalties or interest charges accrued to Wise Stores from delayed payment. This effectively amounted to financial assistance from Peoples to Wise Stores.

The court found that, given Wise Stores' inevitable insolvency, the directors of Peoples owed the duties ordinarily owed to shareholders to the creditors of Peoples. In the next subsection, I examine the court's analysis of directors' duties, taking that they were owed to creditors as a given. That is, for my purposes, the creditors can be thought of as minority shareholders and the money transferred as a result of the inventory procurement system amounted to a diversion of assets from Peoples to Wise Stores, which benefited the Wise brothers as controlling shareholders of Wise Stores.

3. Directors' Duties in Wise

The (unsecured) creditors of Peoples charged that the Wise brothers as directors breached their duties under s. 122 of the CBCA. The specific finding by Greenberg J. was that the Wise

\(^3\) Ibid., at para. 178.
\(^4\) Ibid., at para. 101.
brothers breached their duty of care to Peoples. It is my contention that this finding was misguided. Issues of fiduciary duty, not negligence, were appropriately at issue in the case. I will first evaluate the court’s approach to the duty of care claim on its own terms, then relate it to the relevant fiduciary duty issues.

As set out above, the standard in applying the duty of care is quite deferential to directors and officers. They are not liable for “errors in judgment”, but only for “gross negligence”. In my view, the case for “gross negligence” was not made out in Wise.

Greenberg J., while ultimately relying on the duty of care to ground liability, was imprecise in his evaluation of directors’ duties. He repeatedly referred to fiduciary duty issues, such as whether the Wise brothers were acting for the benefit of Peoples in their role as its directors, while ostensibly reviewing matters under the duty of care. This tendency is illustrated by his consideration of the duties of directors in the context of corporate groups of affiliated companies.

The Wise brothers argued that they, as directors of both Peoples and its parent company, Wise Stores, had latitude when acting as directors of Peoples to consider the interests of Wise Stores. In support, the brothers cited Hadden, Forbes and Simmonds, who write, “No doubt, where a subsidiary is wholly-owned, the interests of the group as a whole may be legitimately preferred to those of the individual company. But where there are minority shareholders, the conflict of interest cannot be avoided.”

In concluding that directors owe duties only to the corporation of which they are directors, Greenberg J. cited another passage from the same book. The authors write,

It is an established legal rule that holding and subsidiary companies must be regarded as separate legal entities in the same way as any other company, and that their directors and officers must look to the interests of their own company to the exclusion of those of other companies within the group or of the group

85. Greenberg J. states that, “it is clear to this Court that the evidence has established beyond a preponderance that in instituting and continuing the new domestic inventory procurement policy and in failing to monitor or have monitored the burgeoning interest thereafter, the three Wise Brothers failed to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances, thereby violating the obligations incumbent upon them in virtue of Section 122(1) C.B.C.A.”: ibid., at para. 80.
86. City Equitable, supra, footnote 33; Brazilian Rubber, supra, footnote 34.
as a whole . . . The formal legal rule, however, is often ignored both in corporate practice and in the decisions of the courts. 88

Greenberg J. stated that "It is not the intention of this Court to ignore that rule." 89 He reviewed a number of cases involving directors' duties in the context of corporate groups 90 and concluded that:

[T]he directors of a wholly-owned subsidiary may consider the best interests of the parent and, where those and the best interests of the subsidiary overlap or coincide, they may act accordingly. Where those respective interests are not congruent, they must attempt to conciliate the two. Hence, where there is a mutuality of interests, there is no problem. However, where the best interests of the subsidiary are in direct conflict with those of the parent, the former must prevail in regard to the actions of the directors of the subsidiary. 91

As I will explain, Greenberg J.'s analysis of corporate groups is correct, but essentially beside the point: the analysis is relevant to fiduciary duties, but not the duty of care, which was the duty at issue in Wise. On its correctness, let us return to the contractual analysis set out above. What "contractual" fiduciary term would controlling shareholders strike with the minority of a subsidiary? Clearly, if some action is in the interests of both corporations, the controlling shareholder would want to be able to pursue it, and the minority would want to encourage it. On the other hand, if an action is in the interests of the parent but not the subsidiary, there will be a conflict of interest between the controlling shareholder and minority shareholders in the subsidiary. However, when selling shares in the subsidiary to the public (that is, at the time of negotiation over the corporate contract), it is reasonable to contend that controlling shareholders would want to commit not to cause the subsidiary to benefit its parent at its own expense. Any action can be made to be in the best interests of the subsidiary through payments from the parent to the subsidiary. If the parent cannot pay the subsidiary corporation such that both corporations are better off from an action, then the action is on balance not adding value. Contracting parties will generally want to commit not to

89. Wise, ibid., at para. 172.
91. Wise, supra, footnote 7, at para. 188.
take value-reducing actions, since both parties can be made better off by avoiding them. Thus, the controlling shareholder would want to commit to the subsidiary not to take actions against the subsidiary’s interests, since that ensures that only value-adding transactions will take place. Both the controlling shareholder and the minority shareholders are better off with a rule that ensures such fidelity to the subsidiary’s interests.

Turning to the relevance of Greenberg J.’s analysis of duties in corporate groups, recall that the court’s only specific finding was that the directors of Wise were negligent in adopting the domestic procurement policy. If a violation of the duty of care grounds liability, it is not of much importance whether the duty is owed to a subsidiary or to a parent. Negligence by managers of a subsidiary implies a disregard for the subsidiary, which generally harms both the subsidiary and the parent corporations. Whether the duty of care is owed to the subsidiary or the parent, neglect of the subsidiary will breach the duty. Greenberg J.’s analysis of corporate groups, then, does not seem relevant to the possible negligence of the directors of Peoples.

On the other hand, the analysis of groups is relevant to an assessment of whether the Wise brothers were acting honestly and in good faith with a view to the best interests of Peoples when they adopted the new domestic procurement policy. Indeed, the court slides back and forth between the fiduciary duty aspect of the case and the duty of care aspect. In two consecutive sentences that illustrate the confusion, Greenberg J. states, “[I]t is clear that, in instituting the new domestic procurement policy, the Wise brothers preferred the interests of Wise Stores over those of Peoples. There was a reckless disregard by them of the negative financial implications resulting from that new policy.” 92 The second sentence does not sit well with the first. The first sentence implies that the Wise brothers advertently shifted assets from Peoples to Wise Stores. The second implies that the Wise brothers were reckless in disregarding negative effects on Peoples. But if the Wise brothers preferred the interests of Wise Stores to those of Peoples, it was not reckless

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92. Ibid., at para. 69. At other points in the opinion, the court explicitly states that the directors of Peoples did not act in its best interests. For example, the court states that counsel for the Wise brothers argued that “the individual Respondents were entitled to ignore the interests of Peoples as such and make decisions concerning the latter by taking into account only the best interests of Wise Stores. This, we find, is in fact what they did.” Ibid., at para. 168.
disregard of the negative implications to Peoples that led them to adopt the policy, but rather it was adopted because of the negative implications.

By stating that the Wise brothers acted in Wise Stores’ interests, not Peoples’, when acting as directors of Peoples, it is their fiduciary duty, not the duty of care, that is engaged. However, any claim based on fiduciary duty appears precluded by the following statement by Greenberg J.:

We hasten to add that in the present case, the Wise Brothers derived no personal benefit from the new domestic inventory procurement policy, albeit that, as the controlling shareholders of Wise Stores, there was an indirect benefit to them. Moreover, as was conceded by the other parties herein, in deciding to implement the new domestic inventory procurement policy, there was no dishonesty or fraud on their part.93

The significance of the “directness” of the Wise brothers’ interest in the new policy is not apparent. In matters of self-interested transactions, CBCA scrutiny arises under s. 120 whenever a director has a “material interest” in a transaction. Whether the material interest is “direct” or “indirect” is not relevant to the underlying concern about directors and officers diverting corporate assets to themselves through favourable transactions with the corporation.

However, the concession by the parties that there was no dishonesty or fraud, which is related to the language of fiduciary duty in CBCA s. 122, may have deterred the court from making a finding under the fiduciary duty. The parties in turn may have wished to avoid findings under fiduciary duty, rather than the duty of care, because of insurance issues: CBCA s. 124 precludes insurance or indemnification for breaches involving dishonesty, bad faith or not acting in the best interests of the corporation. Such a limitation no doubt restricted the court and could well explain the result of the case: Greenberg J. found a breach of duty and wanted to attach liability, even if the breach was characterized as a breach of the duty of care.

The court, then, can be fairly characterized as canvassing issues ordinarily relevant to fiduciary duties, but finding on the basis of the duty of care because of the parties’ concessions. While this may be an understandable reaction, in my view it was nevertheless inappropriate. Different standards of scrutiny apply to the duty of care and to fiduciary duties, and with good reason: a deferential

93. Ibid., at para. 180.
standard is appropriate for the duty of care, but not for fiduciary duties. In the present case, the Wise brothers were the controlling shareholders of Peoples, holding a 75% stake in the corporation through their 75% ownership of the equity in Wise Stores. It simply seems economically implausible that they were negligent in acting as directors of Peoples, given the stakes they had in any loss to Peoples. Given the economic implausibility of negligence, Greenberg J. ought to have been particularly reluctant to find negligence.

Instead, Greenberg J. applied a very strict duty of care, almost certainly because of factors relevant to fiduciary duties. To evaluate the duty of care alone on the facts, rather than relying only on ownership structure, imagine that Peoples and Wise Stores were at arm’s length and the Wise brothers were simply directors of Peoples when instituting the new policy. It was clear that there were problems with the existing procurement system and that something had to be done. They asked their vice-president of administration and finance to come up with a solution. He proposed the new system, which he thought would solve the problem. While there was no formal directors’ meeting about the policy, it is highly debatable whether one was necessary. Moreover, the brothers did hold informal discussions among themselves and they were the sole

94. Ziegel et al., supra, footnote 10, at p. 482 state, “[A] source of confusion in the American cases... arises from the fact that some courts have applied the business judgment rule in breach of fiduciary duty cases where it is inappropriate, rather than confining it to duty of care cases where it had its genesis and where its application is appropriate.”

95. The stake may be misleadingly high because of the importance of creditors. If debt is riskless, any increase or decrease in the corporation’s worth accrues to shareholders. However, if the debt is risky, some increases or decreases will accrue to creditors as the likelihood of repayment fluctuates with corporate value. In the present case, it was clear that the debt was risky, indicating that even 100% ownership of the equity would not imply perfect incentives to maximize the value of the corporation: Jensen and Meckling, supra, footnote 11. Nevertheless, the 75% stake in Peoples would have remained an economically important motivator for the Wise brothers. Indeed, at the time of the purchase of Peoples in 1993, insolvency did not appear particularly likely. Contemporary press reports were enthusiastic about the acquisition and Wise/Peoples’ prospects (see, e.g., Patrick Bloomfield, “Finding New Stocks with an Old Test”, The Financial Post (September 29, 1993) (describing Wise Stores’ shares as a good investment)) — this is a reminder of the perils of evaluation in hindsight.

96. Greenberg J. appears to reason in the following way: since the policy turned out badly for Peoples, it was therefore a profound change that required director approval at the time it was adopted. Yet this may simply reflect a hindsight bias. At the time the policy was adopted, when both companies were reasonably solvent, it may not have appeared particularly fundamental. After all, at the time of adoption, a similar system, but this one favouring Peoples, existed for imported merchandise.
directors, so it was unclear what value a formal directors’ meeting would have added. The brothers did appear informed, both through their own considerations and through their reliance on their vice-president, and any grounds for finding negligence seem to run counter to the established standard of care. The brothers had little economic incentive to be negligent, and there is little evidence on the record that this was a decision made without consideration.

The court’s finding that there was a violation of the duty of care does not sit comfortably with economic logic and the facts. Instead, the finding was clearly influenced by the fiduciary aspects of the case. It is, however, important to keep the standards of review distinct. If a decision is tainted by self-interest, the more stringent standard applicable to fiduciary duties should apply since it is economically plausible that diversion is an attractive option for managers, particularly if they are controlling shareholders. Negligence, on the other hand, is not very plausible where there is a controlling shareholder. Applying the duty of care informed by fiduciary analysis risks eliding the standards; relying on the strict duty of care analysis in *Wise* in another case in which there is no hint of self-interest would be inappropriate. Particularly where there is a controlling shareholder, judicial application of the duty of care should be deferential, while application of fiduciary duties should not.

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98. It is difficult to conclude what the appropriate outcome would be if Greenberg J. had explicitly treated the case as one involving a fiduciary duty. The court found as a fact that the Wise brothers derived no personal benefit from their actions, which clearly cuts against a finding of a breach. Moreover, the parties all conceded that there was no dishonesty or fraud. However, the court did find an “indirect” benefit to the brothers through their controlling stake in Wise Stores. The CBCA makes no distinction between “direct” and “indirect” interests in the provision addressing self-interested transactions. Instead, s. 120 requires directors with a “material” interest in a transaction to disclose their interest in a transaction and refrain from voting to approve it. The Wise brothers made no such explicit disclosure of what appeared to be a material interest (a controlling interest in the beneficiary is presumably material) in the financial assistance that Peoples would effectively be advancing to Wise Stores, nor did they take any steps to sanitize the transaction with a vote of disinterested parties. Of course, there were no minority shareholders, only creditors. Nor were there disinterested directors. This confuses the matter. If one accepts the court’s finding that the brothers owed duties to the creditors when adopting the inventory procurement policy, a conclusion on which I pass no judgment, on balance, in my view, there was a strong claim that the Wise brothers breached their fiduciary duties given their interest in Wise stores, the financial assistance given to it by Peoples, and the absence of any effort to have other parties, such as the creditors, ratify the arrangement.
V. CONCLUSION

The reasoning in Wise invites an examination of the relationship between ownership structure and the duties of directors and officers. Courts should rarely characterize behaviour as negligent where such negligence is not economically plausible because of concentrated ownership. In the Wise case, the Wise brothers had a strong financial interest in avoiding negligence through their equity ownership of Wise Stores, but may well have had an incentive to disregard the creditors of Peoples in favouring Wise Stores over its subsidiary. Indeed, as a general proposition, negligence seems unlikely, but violations of the fiduciary duty do not, where there is a controlling shareholder.

In its reasons, if not in its particular legal findings, the court in Wise was unclear as to the precise grounds for liability. Given that the standards of scrutiny vary considerably depending on the duty in question, with good reason, courts should be very clear as to whether they are scrutinizing the behaviour of directors and officers under the duty of care or fiduciary duty. Doing otherwise risks eliding the standards applicable in different settings. Especially where there is a controlling shareholder, courts ought to review duty of care allegations with considerable deference to managers, but should set aside this deference when adjudicating fiduciary duties.